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## CHOICE OF ENTITY

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### I. Introduction.

- A. The choice of an entity in which to conduct business is a complex one. Many factors should be considered, including the individual circumstances of the owners of the business, the business's prospects, and local law. There are no rules of thumb.
- B. The choice of entity involves both tax and nontax considerations. Tax and business advisors should be involved in the decision-making process from the outset.
- C. Planning will change as a result of the Omnibus Budget Reconciliation Act of 1993 (the "1993 Act"). Rate and other changes will affect the analysis. Beware of some of the oversimplistic pronouncements that have appeared in the popular press, however. The process will still be complex, although some of the considerations have changed.

### II. Tax considerations.

- A. Effect of tax rates.
  - 1. Preliminary caveat: this outline considers only federal tax rates. State and local tax rates should be considered in any analysis.
  - 2. An analysis of comparative tax rates imposed with respect to different types of business entities must take into account the projected levels of income. An analysis based on maximum tax rates will be useless if the business does not generate enough income to rise into the top brackets.
  - 3. An analysis of rates should take into account the allocation of the business's income among the entity and its owners.
    - a. In a flow-through entity (e.g., S corporation, partnership, limited liability company ("LLC")), all of the income will be taxed to the owners, regardless of whether it is distributed.
    - b. In a C corporation, the income may be divided among the corporation and the shareholders.

4. Before the 1993 Act, the scales normally tilted in favor of a flow-through entity.
  - a. The maximum individual rate was lower than the maximum corporate rate.
  - b. The maximum corporate rate was reached at a low level of taxable income (\$75,000) so most individuals were in a lower tax bracket than their corporations.
  - c. Tax practitioners generally advised their clients to use a flow-through entity unless special circumstances were present.
  - d. Even if the business needed to accumulate income, it was cheaper from a tax standpoint to have all the income taxed directly to the owners and to have the entity distribute that amount of income that it did not need.
5. Under the 1993 Act, the effect of rates will vary according to the circumstances. Not all individuals will be in higher tax brackets than C corporations.
6. Examples of the analysis under the 1993 Act. In each case, assume that X, the business entity, is owned entirely by A, an individual, and that A has no other sources of income unless otherwise indicated. A is married and files a joint return.

Example I

- (1) X has \$200,000 of taxable income before A's salary and needs to retain \$150,000 of it in the business. It pays A a salary of \$50,000.
- (2) If X is a C corporation, X has taxable income of \$150,000 and pays a tax of \$41,750. A has taxable income of \$50,000 and pays a tax of \$9,203. The total tax is \$50,903.
- (3) If X is an S corporation, X is not taxed. A has taxable income of \$200,000 and pays a tax of \$57,529.
- (4) If a C corporation is used, the tax is lower by \$6,626.

### Example II

- (1) Same facts as example I, but A has other investment income of \$500,000.
- (2) If X is a C corporation, X has taxable income and pays a tax of \$41,750. A's tax on the \$50,000 salary is \$19,800 (39.6%), producing a total tax of \$61,550.
- (3) If X is an S corporation, X is not taxed. The tax on A's additional \$200,000 of income is \$79,200 (39.6%).
- (4) If a C corporation is used, the tax is lower by \$17,650. In general, wealthy shareholders may prefer the C corporation structure, subject to the double tax on retained earnings discussed below.

### Example III

- (1) X has \$200,000 of taxable income and keeps it all in the business.
  - (2) If X is a C corporation, X has taxable income of \$200,000 and pays a tax of \$61,250. A pays no tax.
  - (3) If X is an S corporation, X pays no tax. A has taxable income of \$200,000 and pays a tax of \$57,529.
  - (4) If a C corporation is used, the tax is higher by \$3,721.
7. If a C corporation is used, the possible imposition of a second tax on earnings that are not paid out currently must be taken into account.
- a. If they are later distributed as dividends, there will be a shareholder-level tax with no offsetting deduction for the corporation.
  - b. If the corporation's stock is later sold, the retained earnings will be taxed at capital gains rates.

B. Tax on sale of business.

1. If the assets of a C corporation are sold, or if the stock of a C corporation is sold and the buyer elects to step up the basis of the corporation's assets under I.R.C. section 338, there will be a corporate-level tax and a shareholder-level tax. The combined taxes, if the corporation is in the 34% bracket and the shareholders are in the 28% bracket on capital gains, will be 52.5%.
2. If the stock of a C corporation is sold and a section 338 election is not made, the only tax will be a shareholder-level capital gain tax at 28%, but the buyer may insist on paying a lower price because of its inability to step up the basis of the assets.
3. If a flow-through entity is used, there is no entity-level tax. The only tax is a shareholder-level capital gain tax at 28% and the buyer can step up the basis of the assets.
4. The significance of the double tax on the sale of the business is affected by the imminence of the sale.
  - a. If the owners hope to sell the business at a profit in a few years, the tax burden on a sale may be very important.
  - b. If the owners are young and plan to continue the business indefinitely, the tax impact on a sale may be less important to them.
    - (1) The present value of future tax liabilities may be low.
    - (2) It is impossible to predict what the tax rules and rates will be in the distant future. For example, the double tax on asset sales of C corporations may have been repealed and the individual rates may be much lower than they are now.
5. Tax-free sale of a business.
  - a. A corporation can be sold tax-free to another corporation in a tax-free transaction if the shareholders take back stock of the buyer. I.R.C. § 368.

- (1) The extent to which the consideration must be buyer stock varies according to the form of the transaction. In some cases, all of the consideration must be buyer stock. In other cases, only a substantial part of the consideration must be buyer stock.
  - (2) Gain is taxed to the extent that the consideration is cash or property other than buyer stock.
  - (3) The tax-free reorganization rules apply to sales of S corporations as well as to sales of C corporations.
- b. The business of a partnership or an LLC can be sold tax-free only in the relatively unusual situation in which a tax-free exchange of like-kind property can be arranged. I.R.C. § 1031.
  - c. A corporation, unlike a partnership or an LLC, can acquire another business in exchange for its stock under I.R.C. section 368. It may be possible to arrange a similar transaction in the partnership or LLC context by using a capital contribution under I.R.C. section 721.

C. Double tax on income of C corporations.

1. The problem.

- a. C corporations and their shareholders are each subject to income taxation. If a C corporation pays its earnings to shareholders as dividends, the earnings will be taxed first to the corporation and then a second time to the shareholders. (The corporation cannot deduct dividends paid to shareholders.)

Illustration: Corporation earns \$100. It pays tax of \$34 (34%). It distributes the remaining \$66 to its shareholders as a dividend. They pay tax of \$26.14 (39.6%), leaving \$39.86 after taxes. The total tax paid by both the corporation and its shareholders is 60.14%.

- b. One of the principal tax problems for closely-held C corporations and their shareholders is to get corporate earnings to the shareholders without paying a double tax. The objective is for payments from the corporation to the shareholders to be in a form that permits them to be deducted by the corporation.

2. Compensation.

- a. Rule of law: if the corporation pays shareholders compensation for services rendered to the corporation, the shareholders are taxed on the amounts received and the corporation can deduct them if they are reasonable in relation to the work done.
- b. Problem to be overcome: the I.R.S. may claim that amounts that purport to be compensation for services rendered by shareholders in their capacity as employees are really nondeductible distributions of corporate earnings to the recipients in their capacity as shareholders.
- c. Tests applied by the I.R.S. and the courts in determining whether compensation is deductible by the corporation.

(1) It must be intended to be payment for services rendered to the corporation.

- (a) A year-end "bonus" that just happens to be equal to the corporation's undistributed earnings for the year is likely to be held to be a dividend, even if, when taken together with other amounts paid to the shareholder-employee, it would not be unreasonable in amount. Builders Steel Co. v. Commissioner, 197 F.2d 263 (8th Cir. 1932).

Planning: spread bonuses throughout the year.

Planning: do not pay out all the year's earnings in year-end bonuses.

Planning: do not base bonuses on a percentage of profits. A percentage of gross sales is safer.

- (b) The I.R.S. will look carefully at compensation that is paid in proportion to shareholdings. Charles McCandless Tile Service v. U.S., 422 F.2d 1336 (Cl. Ct. 1970).
- (c) A failure of the corporation to pay dividends equal to a reasonable return on its capital may suggest to the I.R.S. and the courts that what purports to be compensation is really a dividend. McCandless, supra. The I.R.S. has rejected an automatic dividend approach, however. Rev. Rul. 79-8, 1979-1 C.B. 97.

Planning: consider paying dividends equal to a reasonable return on invested capital.

- (d) The compensation arrangement should be reflected in corporate minutes and employment agreements adopted before the services are performed.
- (2) It must be reasonable in relation to services performed.
- (a) Compensation paid under a formula that is reasonable when the arrangement is agreed on will be considered reasonable even if the dollar amount is exceptionally high. Kennedy v. Commissioner, 671 F.2d 167 (6th Cir. 1982); Automotive Investment Development Inc. v. Commissioner, T.C. Memo. 1993-298.
  - (b) Factors that are considered in determining reasonableness of compensation.
    - (i) Consistency with past compensation levels of the employee and other employees.

- (ii) Compensation paid to employees exercising similar responsibilities in other companies in the same business. Trucks, Inc. v. U.S., 84-1 USTC ¶ 9418 (D. Neb. 1984).

Planning: CPA firm may be helpful in assembling information on pay scales in the industry.

- (iii) Qualifications of the employee (e.g., education, business experience, leadership in the profession).
- (iv) Work done by employee (long hours, short vacations, etc.).
- (v) Contribution to success of business (e.g., attracted customers, technological know how, developed systems).

- (c) Compensation can be paid for services rendered in past years.

d. Hedge agreements.

- (1) The I.R.S. will allow an employee to deduct amounts paid to a corporation pursuant to an agreement requiring the repayments of amounts held to be unreasonable compensation if the following requirements are met [Rev. Rul. 69-115, 1969-1 C.B. 50; Oswald v. Commissioner, 49 T.C. 645 (1968)]:

- (a) repayment was required by a corporate bylaw or board resolution;
- (b) the bylaw or resolution was adopted before the year in which the services were performed;

(c) the employee signed an agreement requiring repayment or knew of the bylaw or resolution before the year in which the compensation was received; and

(d) the employee's repayment obligation was enforceable by the corporation under local law.

(2) Disadvantages of hedge agreements.

(a) The employee will not want to repay the disallowed amounts.

(b) The existence of the agreement may be viewed by the I.R.S. and the courts as indicating an awareness that the compensation was unreasonable. Charles Schneider & Co. v. Commissioner, 500 F.2d 148 (8th Cir. 1974), cert. denied, 420 U.S. 908 (1975).

3. Leasing.

a. The technique: shareholders may keep some property needed for the business out of the corporation and lease it to the corporation.

b. Advantages of leasing property to the corporation.

(1) Rental payments are a way of getting cash from the corporation to the shareholders.

(2) The corporation can deduct the rental payments so there is no double tax on the corporate income that provides the cash needed for the rental payments.

(3) The shareholders can depreciate the leased property. The rental income may be tax-free.

(4) The property may be given to family members or to a trust for their benefit and be used to split income and property for income and estate tax planning purposes.

- (5) If the property is sold, the proceeds go to the shareholders and can be used for personal needs. If the corporation needs the money, the shareholders can lend it to the corporation or contribute it to the corporation's capital without undesirable tax consequences. (If property owned by the corporation is sold, the proceeds cannot ordinarily be distributed to the shareholders without being taxed as a dividend.)
- c. Disadvantages of leasing property to the corporation.
- (1) The property is not shown as an asset on the corporation's financial statements. This may reduce its borrowing power.
  - (2) The lease involves extra paperwork and some accounting complexity.
- d. Sale-leasebacks.
- (1) Technique: if property is already owned by the corporation, it can be sold to the shareholders and leased back to the corporation, producing many of the advantages described above.
  - (2) Problems to be considered in planning a sale-leaseback.
    - (a) The price that the shareholder pays to the corporation should be reasonable. If the shareholder pays less than the property's value, the difference will be taxed to him or her as a dividend.
    - (b) The shareholders may wish to pay the purchase price over a period of years, particularly if the purchase price is high, as will normally be the case if the property is real estate.

- (i) The lease payments can be set at an amount that will cover the installment payments of the purchase price. They must be reasonable in relation to the property's rental value.
  - (ii) The corporation must charge interest at a rate at least equal to 110% of the rate charged on U.S. Treasury obligations of comparable maturity. I.R.C. § 1274(e).
- (c) The arrangement must be treated as a sale and lease for tax purposes, not as a secured loan. The lease must be treated as a lease and not a sale. Generally, the arrangement should withstand I.R.S. attack if the terms are reasonable and any option in the corporation to repurchase the property is for a fair price. See Frank Lyon Co. v. U.S., 435 U.S. 561 (1978).
- (d) If the sale is to a trust for family members, the trust should be operated in a true fiduciary manner in the best interests of the beneficiaries. Ideally, the trustee should be independent. Similarly, if the sale is to a family partnership, the interests of all partners should be protected.
- (3) The corporation will be taxed on any gain realized on the sale.
- (a) If the shareholder owns 80% or more of the value of the corporation's stock and the property is depreciable, the corporation's gain will be ordinary income. I.R.C. § 1239.

(b) In any event, the corporation's gain will be ordinary income to the extent required by the depreciation recapture rules. I.R.C. §§ 1245, 1250.

4. Flow-through entities are not subject to the double tax imposed on C corporations and their shareholders.
  - a. In general, compensation can be paid to shareholder-employees without being challenged by the I.R.S.
  - b. The I.R.S. might challenge the reasonableness of compensation on which contributions to tax-sheltered retirement plans are based.

D. Deductibility of losses.

1. If a C corporation is used, start-up losses do not produce current deductions for the owners. They become net operating loss carryovers and produce tax benefits only when, and if, the corporation generates taxable income against which they can be offset.
2. If a flow-through entity is used, losses are passed through to the owners and are deductible by them currently to the extent of their investment in the entity.
  - a. Partnership and LLCs.
    - (1) Losses are deductible to the extent of the partner's basis in the partnership interest. I.R.C. § 704(d).
    - (2) Loans from the partner to the partnership do not increase the partner's basis in his or her partnership interest except to the extent that they are allocated to the partner under the normal rules relating to nonpartner loans.
  - b. S corporations.
    - (1) A shareholder can deduct losses to the extent of the basis of his or her stock in and loans to the corporation.

(2) In general, loans from a third party that are guaranteed by the shareholder are not treated as shareholder loans for this purpose. See, e.g., Uri, Jr. v. Commissioner, T.C. Memo. 1989-58, aff'd, 949 F.2d 371 (10th Cir. 1991); Estate of Leavitt v. Commissioner, 90 T.C. 206 (1988), aff'd, 875 F.2d 420 (4th Cir. 1989), cert. denied, 493 U.S. 958 (1989). But, see Selfe v. United States, 778 F.2d 769 (11th Cir. 1985) (transaction treated as loan to shareholder followed by loan to corporation when lender relied primarily on shareholder's credit).

3. Application of passive activity loss rules.

- a. Losses from certain passive activities are generally deductible by owners of flow-through entities only to the extent of their income from passive activities. I.R.C. § 469.
- b. Although closely-held C corporations are subject to the passive activity loss rules, C corporations (other than personal service corporations) can deduct passive activity losses against income from business operations other than portfolio investment income. S corporations cannot. I.R.C. § 469(e)(2).

E. Employee fringe benefits.

1. The rules for tax-sheltered retirement plans are comparable for corporate employees and for self-employed persons.
2. Shareholder-employees are eligible for a variety of tax-sheltered fringe benefits that are not available to partners, members of LLCs, and persons owning more than 2% of the stock of an S corporation (defined as meaning the outstanding stock or the combined voting power of all stock). These include health and accident plans (self-employed persons can deduct up to 25% of contributions), disability insurance, cafeteria plans, and employer-provided meals and lodging.

F. Restrictions on the use of S corporations.

1. The Internal Revenue Code limits the availability of the S election. Not all corporations are eligible. Other entities (including LLCs) are not subject to these restrictions.
2. I.R.C. Subchapter S requirements.
  - a. The corporation must be a domestic corporation. I.R.C. § 1361(b)(1).
  - b. The corporation may not have more than 35 shareholders. I.R.C. § 1361(b)(1)(A).
  - c. Only individuals, estates, and certain trusts may be shareholders. I.R.C. § 1361(b)(1)(B).
  - d. A nonresident alien may not be a shareholder. I.R.C. § 1361(b)(1)(C).
  - e. The corporation may not have more than one class of stock, except for stock that differs only as to voting rights. I.R.C. § 1361(b)(1)(D).
  - f. The corporation may not be a member of an affiliated group of corporations within the meaning of I.R.C. section 1504 (e.g., it may not have 80%-owned subsidiaries). I.R.C. § 1361(b)(2)(A).
  - g. The corporation may not be a bank, an insurance company, a possessions corporation, or a DISC or former DISC. I.R.C. §§ 1361(b)(2)(B), (C), (D), and (E).
3. Certain states and cities do not recognize S elections and impose a double tax on S corporations and their shareholders.

G. 1993 Act exclusion for gains on certain C corporation stock. I.R.C. § 1202.

1. A shareholder other than a corporation can exclude 50% of the gain from the sale or exchange of "qualified small business stock."
2. The stock must have been held for more than five years.

3. Excludable gain from stock of any one corporation in any one year cannot exceed the greater of:
  - a. \$10,000,000, reduced by excluded gain from prior years attributable to the corporation, or
  - b. Ten times the basis of the corporation's stock that is disposed of during the year.
4. Definition of qualified small business stock.
  - a. The corporation must be a C corporation.
  - b. The corporation must be a domestic corporation.
  - c. The shareholder must acquire the stock at its original issuance (unless it is acquired on the conversion of qualified stock or in certain specified transfers).
  - d. In general, the corporation must be engaged in an active business. Excluded businesses include personal services, investing, banking, leasing, and farming.
  - e. The stock is issued after August 10, 1993.
  - f. The corporation's gross assets (cash and adjusted basis of other property) do not exceed \$50,000,000 at all times after August 9, 1993 and up to the date of issuance and immediately after the date of issuance taking into account amounts received in the issuance.
5. Protective anti-abuse provisions are included.

### III. Nontax considerations.

#### A. Limited liability.

##### 1. Corporation.

- a. A corporation (whether C or S) provides limited liability in the sense that shareholders are generally not liable for the debts of the corporation (although their investments in the corporation can be lost).

- b. The protection of limited liability can be diluted.
  - (1) Lenders will often require the shareholders of a corporation to guarantee loans to the corporation.
  - (2) Liability of shareholder-employees for their own acts.
    - (a) An employee of a corporation will generally be personally liable for the consequences of his or her own acts.
    - (b) Professional service corporation statutes often require a professional to be personally liable for the consequences of persons working under his or her supervision.
  - (3) Shareholders under the laws of some states may be liable for a failure to pay wages.
  - (4) Persons responsible for the payment of employment taxes may be personally liable for their payment (by the mechanism of a 100% penalty) if the corporation fails to do so. I.R.C. § 6672(a).

2. General partnership.

- a. The partners of a general partnership are fully liable for the partnership's debts.
- b. The partners may agree among themselves as to the allocation of liability, but this does not bind third-party creditors.
- c. Individual partners can reduce their exposure by forming single-purpose S corporations to be the partners. Corporate partners can get the same protection by forming single-purpose subsidiary corporations (with which they file consolidated returns) to be the partners.

3. Limited partnership.

- a. The limited partners of a limited partnership are not liable for the partnership's debts. The general partner is fully liable. The use of a shell corporation as the sole general partner may result in the partnership being treated as a corporation for tax purposes.
- b. A limited partner may lose the protection of limited liability if he or she participates too actively in the partnership's affairs.
- c. As in the case of a corporation, third-party lenders may require limited partners to guarantee loans to the partnership.
- d. Limited partners who are responsible for seeing that the partnership pays employment taxes may be personally liable if the partnership fails to pay them. I.R.C. § 6672(a).

4. Limited liability company.

- a. An LLC generally provides the same protection against personal liability as does a corporation.
- b. Many states do not recognize LLCs. If a state in which an LLC does business treats the LLC as a partnership for liability purposes, the owners will not have limited liability with respect to LLC actions in that state, even if the state in which it is formed recognizes LLCs.

B. Familiarity of laws.

1. The corporate law in most states is well-developed.
  - a. The basic provisions have been in effect for years and lawyers are generally familiar with them.
  - b. They have been interpreted by many court cases.
2. Partnership laws are generally not as well-developed as corporate laws, but they, too, have been in place for some time.

3. LLCs are new. The laws in different states vary, they are new, and they have not been the subject of extensive judicial interpretation.

C. Management.

1. Corporation.

- a. Corporate management procedures are generally prescribed by statute.

- (1) The rules are laid down by law. If the shareholders have not prescribed operating procedures, there is a legal framework to fill the gap.

- (2) The statutes may limit the ability of shareholders to develop their own management structure.

- b. To the extent that they do not conflict with the statute, the shareholders are free, through the certificate of incorporation, the bylaws, and separate agreements, to design a management structure that fits their needs.

2. Partnership.

- a. The partners are generally free, through the partnership agreement, to design a management structure that fits their needs.

- b. Limited partners cannot be given too much management responsibility without losing their limited liability.

3. Limited liability company.

- a. LLCs are apparently similar to partnerships in their general flexibility.

- b. The lack of case law and the recent vintage of the LLC statutes may create uncertainty as to permissible management structures.

D. Continuity of existence.

1. A corporation has perpetual existence. The owners do not have to worry about termination of the entity if a member dies or withdraws.

2. A partnership theoretically terminates for purposes of local law (although not for tax purposes) if a partner dies or withdraws. This problem can easily be cured if it is addressed in the partnership agreement.
3. An LLC can generally be designed to have continued existence that survives the death or withdrawal of a member.

E. Transferability of interests.

1. Interests in a corporation are generally the most easily transferable. Unless restricted by a shareholders agreement, shares can be transferred by delivering a stock certificate endorsed or with a stock power.
2. Interests in a partnership can generally not be transferred without the consent of the other partners to admit the new partner (although the economic interests can often be transferred without conferring partner status on the transferee).
3. LLCs can generally be designed to have free transferability of interests.

F. Ease and expense of organization.

1. The basic documents of forming a corporation can generally be prepared more easily and cheaply than can the basic organizational documents of the other entities. Standard forms are available and are usually adequate.
2. This advantage of the use of the corporate form disappears, however, if there are two or more shareholders, because the negotiation and preparation of a shareholders agreement, which should always be used, can be as expensive and time-consuming as the negotiation and preparation of the organizational documents for a partnership or an LLC.